CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 2 EXAMINATIONS

A2.1: STRATEGIC CORPORATE FINANCE

THURSDAY: 5 DECEMBER 2019

INSTRUCTIONS:

1. **Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 Minutes writing).
2. This examination has two sections: A & B.
3. Section A has **one** Compulsory Question while section B has **three** optional questions to choose any **two**.
4. In summary attempt **three** questions.
5. Marks allocated to each question are shown at the end of the question.
6. Show all your workings.

SECTION A (Compulsory)

QUESTION ONE:

KAMU Business Ltd (KB Ltd) has been in the business of car repairs, selling spare parts imported from Dubai and Europe. The company's performance for the last two years is as below:

Income statement

	2018	**2017**
	Rwf	Rwf
Sales revenue	7,200,000,000	6,000,000,000
Cost of sales	3,450,000,000	2,970,000,000
Gross profit	3,750,000,000	3,030,000,000
Net profit	**1,200,000,000**	**1,940,000,000**

Balance Sheet

	2018	**2017**
	Rwf	Rwf
Non-current assets	2,250,000,000	1,945,000,000
Inventory	670,000,000	370,000,000
Trade receivables	295,890,411	500,000,000
Other receivables	39,109,589	80,000,000
Bank and Cash	160,000,000	600,000,000
Total Assets	**3,415,000,000**	**3,495,000,000**
Equity	1,600,000,000	1,500,000,000
Bank loan	950,000,000	1,200,000,000
Trade payables	550,000,000	500,000,000
Bank overdraft	300,000,000	220,000,000
Other current liabilities	15,000,000	75,000,000
Total Equity & Liabilities	**3,415,000,000**	**3,495,000,000**

During the recent senior management meeting, it was resolved that the company needs to revise its strategies, including a sound credit policy and a robust investment strategy.

The CEO of the company hailed the performance made in 2018, specifically the sales growth rate which he says is commendable, but wondered why the net profit reduced and thus called upon a deep assessment of the underlying causes of such reduction. One of the Directors commented that normally an increase in sales accompanied by a decline in profitability is one of the symptoms of overtrading.

Proposed credit policy

The marketing manager tabled a proposal to revise the credit policy for next year:

Increase the credit period from the current 2018 receivable days to 60 days and offer a cash discount of 10% to the customers who would like to pay in the current receivable days. He estimates that this will increase sales revenue by 25% which is a good performance compared to the stiff competition that is coming in the market.

He further estimates that about 70% of the clients will accept the proposed credit policy while the rest will accept the proposed discount terms and that additional sales will also increase operating costs by Rwf 600 million.

The company currently pays 20% of interest on its bank overdraft.

In any other business, the CEO informed the participants on a range of issues, including the call to attend the Umuganda, community-based work organized on the next Saturday and revealed that the company has pledged to donate Rwf 200 million in the district fund towards the rehabilitation of houses of vulnerable people affected by the recent heavy drains that destroyed a lot of properties. One manager, John inquired to why the company would spend that amount of money in social activities that should be the responsibility of the local administration, while the company has been paying taxes. The CEO simply reacted that each company should participate in the community development projects as part of the corporate social responsibility (CSR). The manager replied that he has not heard CSR before and needed to understand it more.

Investment project:

KB Ltd is about to diversify its operations from car repairs into the transport sector. Given the government policy of encouraging Kigali city residents to use public transport to reduce on traffic congestion coupled with increase in Kigali population, KB Ltd is optimistic that the transport industry will continue to grow.

The business development manager has obtained the following information for the proposed investment.

The new investment requires the payment of an up-front license fee to the transport sector regulator of Rwf 10 Billion, acquisition of Buses for Rwf 40 Billion and softwares' including GPS (Speed governor) and other fleet management related software worth Rwf 6 Billion.

Sales revenue and operating costs for the first 3 years have been estimated as follows:

Year/currency	1 “Rwf”	2 “Rwf”	3 “Rwf”
Sales revenue	7 Billion	8.5 Billion	9.5 Billion
Operating costs	4 Billion	4.3 Billion	4.65 Billion

These estimates are based on the current prices, revenue and costs are expected to grow by 5% and 8% respectively. Operating costs exclude depreciations.

The company will benefit from the investment pool which provides incentives to investments in selected sectors. As such, investment for the acquisition of buses will attract a capital allowance of 15% on a reducing balance basis. Considering the business environment, it has been estimated that net cash flows after the 3rd year will grow at the GDP growth rate of 8% for the foreseeable future.

Mr. Amos, a well-known mechanical engineer has estimated the residual values of the buses after three years to be Rwf 10 Billion.

The business will further need an initial working capital of Rwf 1.55 Billion and Rwf 230 for every Rwf 1,000 in sales revenue for the 1st and the 2nd year. The full working capital will be released back in the 3rd year. The combination of business risk and the financing structure shows that the appropriate cost of capital for this type of investment is 25%.

The project will pay corporate income tax at 30% per year and it is assumed that profit earned in a tax year are taxed and paid in that same tax year.

The senior management meeting requested the business development team to carry out the project appraisal by taking into consideration the value creation and the earlier agreed upon principal of investing in project with internal rate of return not less than 30%.

Listing proposal

The company financial manager informed the senior management that the company is soon launching its five-year strategic plan. Part of the strategy is to turn the company into a publicly traded corporation, by listing its shares on the Rwanda stock exchange. One of the requirements that the company should address is the establishment of a good corporate governance, including creation of a board of directors, and improving its reporting framework. This will allow, arguably, the company to respond to the diverging needs of many shareholders that will invest in the company after listing on the stock exchange.

He further stated that one of the challenges to be faced by the management is to address the issue of possible conflicts between management and shareholders’ goals.

He also stated that the company will have to increase its monitoring and interests in the publications/disclosures and news of the National Bank of Rwanda with regard to its monetary policy stance and particularly with the movement in key repo rate and other monetary variables, as these will affect the performance of the capital market in which the company will source its finances.

REQUIRED:

(i) Evaluate the concerns of the director that KB Ltd may be over trading **(6 Marks)**

(ii) Advise on the viability of the proposed credit policy (**6 Marks)**

(iii) Evaluate the viability of the proposed investment in the transport sector **(16 Marks)**

(iv) Using the principal of investing in a project with an internal rate of return not less than 30%, advise whether the project should be undertaken. **(4 Marks)**

(v) Explain to John what corporate social responsibility is and what could be consequences of the companies that ignore it on their performances **(8 Marks)**

(vi) Discuss how improved corporate governance and financial reporting can help in mitigating the agency problem (**4 Marks)**

(vii) Briefly explain how monetary policy interventions may affect the capital market performance. **(6 Marks)**

(Total 50 Marks)

SECTION B (choose any two)

QUESTION TWO:

Karl & Sons Co Ltd (KS Co) Ltd has been in the mining sector for the last 10 years. It has run a successful business by importing sophisticated machines and equipment for gold and tungsten extraction processing and has been exporting half-way processed minerals to Euro Zone. The company's operating currency is Rwandan Francs (Rwf) but most of its equipment and other operating costs are paid in Euro with few materials and expenses, such as salaries for local staff paid in the local currency, the Rwandan Francs.

The company's customers are mostly corporate entities in France, UK and Sweden. As of June 30th, 2019, KS Co had supplied tons of tungsten to three customers in UK, worth £ 45 million. As a result of the Brexit movement, it has been estimated that UK may undergo a recession period which, if it happens, will seriously affect the liquidity of many UK companies. One of the three customers in UK, the Next Tech Generation Ltd (NTG Ltd) has had bad time recently when the daily telegraph announced the expected recession. Its sales revenue dropped by more than a half and as a result the company has had difficulties in paying its suppliers on time.

The second most valuable customer of KS Co Ltd is Tuff Jew Co Ltd (TJC Ltd), a company specializing in luxurious jewellers, based in Sweden. It has placed orders and received supplies of gold from KS Co Ltd worth Euro 50 million that it now owes the payment. KS Co Ltd expects to receive the payment in 3 months from now. Assume today is December 1st, 2019.

One of the equipment suppliers of KS Co is Dall-Bru Co Ltd (DBC Ltd) that is based in Brussels. It has supplied equipment worth Euro 10 million on September 1, 2019 with terms of payment of 6 months.

KS Co Ltd conducts monthly meetings of its senior management to appraise company's performance, risk analysis and to strategize to keep the company coping with the business environment and key changes in the global market. In the recent meeting, the Head of risk management department informed the participants that it is time for the company to start using hedging strategies to cope with the huge exchange losses the company has been facing in the past.

He tabled the following proposal with regard to hedging receipts expected from TJC Ltd and payments to be made to DBC Ltd. He proposed that these future cash flows can be hedged either using forward contracts or money market hedge. He informed members present in the meeting that he has gathered the following information that can be used to select the best hedging mechanism:

Forward Contract

Rwf / Euro	
Spot	0.001080 – 0.001050
3 months forward	0.001075 – 0.001040
6 months forward	0.001070 – 0.001030

<u>Money market contract</u>

The three months interest rate and six months interest rate were quoted by the Bank of Kigali as follows:

	Rwf	**Euro**
Borrowing rate	16%	8%
Deposit rate	9%	3%

During the CEO's tour in the recent concluded business exhibition at Gikondo Ground, the CEO met one of the local equipment company suppliers who convinced that his company, Sophist Machinery Supply (SMS) Ltd can adequately supply key mining tools that KS Co Ltd has been looking for. The estimated value of the order to be placed by KS Co Ltd is Rwf 300 million and the delivery is expected to be made within 3 months from now, upon which KS Co Ltd should make a payment of 10% of the purchase order value. The payment of the rest will be negotiated at good terms for KS Co Ltd, assured the owner of SMS Ltd.

KS Co Ltd plan to finance the required payment with a loan from one of the local banks but expressed worries that given the current trends in financial markets, the interest rate may fluctuate a lot in the coming months and the company is not prepared to undertake this risk.

KS Co Ltd plans to repay back the loan in 6 months.

The company's financial advisor who was present in the meeting offered an idea of using Forward rate agreements. He made a call to one of the local banks which specialises in Forward rate agreements and obtained the following quotes:

3 v 6	15%	- 7%
3 v 9	16%	- 8%
3 v 12	17%	- 9%

The bank suggested that KSCo Ltd can borrow at the Key Repo Rate (KRR) + 1200 basis points.

The current KRR is 5%. The National Bank of Rwanda has already announced that the KRR will be revised upward to 6% on March 1st, 2020.

The meeting concluded on a positive note that all required information is readily available for KS Co Ltd to make sound analysis and be able to make meaningful decisions. However, before the closing remarks of the CEO, the business relations officer informed the participants recently the prices of several minerals including gold and tungsten have been seriously affected on the Mombasa auction market and a down side price movement is expected to continue in the near future. The Head of Human resources management announced that the company has already made a commitment to increase salaries with 15% and reversing this could potentially lead to serious legal consequences.

He also highlighted that the company is expected to pay Rwf 200 million in various court cases it has lost against its former employees.

REQUIRED:

a) Briefly, explain key financial risks facing KS Co Ltd from the issues discussed above **(7 Marks)**

b) Advise KS Co Ltd on the best hedging strategy for the receipt from JJC Ltd and payment to DBC Ltd **(10 Marks)**

c) (i) Explain the main reasons that would push a company to use interest rate swaps in managing its loan portfolio **(3 Marks)**

(ii) Advise KS Co Ltd the best way to hedge against the risk of future interest rate increase when financing the acquisition of Key mining tools from SMS Ltd and how much would be the effective interest rate on the borrowing **(5 Marks)**

(Total 25 Marks)

QUESTION THREE

a) Rwanda Business Investment Group (RBIG Ltd) is an investing company that brought together various investors from within and outside the country. It specialises in Equity and bond markets. It has invested in two securities X and Y with the following financial information

Security	Expected return on the market (in %)	Standard deviations of returns (in %)	Investment level (Rwf)
X	15	4	100 million
Y	20	8	150 million

The covariance between 2 investments was estimated to be 21.4.

The Business manager argued that RBIG Ltd would have done better in investing all its funds in security Y as it offers a higher return of 20% than its counterpart security X. The chief investment officer counter-argued that investment decision should be based on a risk – return analysis and commended the management of RBIG Ltd to have diversified by investing in two different securities.

REQUIRED:

(i) Determine the expected return on RBIG Ltd's portfolio and the level of the risk of the portfolio compared to individual security risks. **(5 Marks)**

(ii) Discuss the arguments and counter – arguments of the two directors risk management through diversification and relate your reasons to answers obtained in (i) **(2 Marks)**

(b) Groceries Ltd is planning to takeover Nyabugogo Clays Ltd. The financial performance of the two companies are as follows:

	Groceries	**Nyabugogo**
After tax net income (Rwf)	520 million	180 million
Dividend just paid (Rwf)	-	36 million
Share capital (Rwf 500 per share)	625 million	400 million
Price per share (Rwf)	1800	

Groceries is listed on Rwanda stock exchange while Nyabugogo clays is not. Both companies are all equity financed. Groceries Ltd offers to acquire Nyabugogo Ltd by offering 1 share for every 4 shares owned and Rwf 225 for each share in cash.

Nyabugogo clays has maintained a constant growth rate of 10% in dividends, and it is expected to keep this level. Its cost of equity has been estimated to be 20%.

Groceries Ltd plans to spend re-structuring costs Rwf 150 million. The before tax cost savings arising from the merging of some support functions after the acquisition is estimated to be Rwf 45 million annually to perpetuity. The information from Rwanda Stock Exchange (RSE) shows that the 15 year – government bond has a return of 15.4% while the return on the market is 23.4%. Groceries Ltd has a Beta of 1.2 and it is not expected to change after the takeover of Nyabugogo Clays Ltd.

Groceries Ltd also plan to remove its shares from stock exchange after acquiring Nyabugogo clays and become a private company. Both companies pay corporate income tax at a rate of 30%.

REQUIRED:

(i) Compute the purchase consideration that will be paid to existing shareholders of Nyabugogo Clays Ltd and how much gain will they get above its current value. **(5 Marks)**

(ii) Evaluate whether the acquisition of Nyabugogo Clays is worth investment to Groceries shareholders. **(9 Marks)**

(iii) Discuss the decision of Groceries Ltd to become a private company after acquiring Nyabugogo Clays explaining advantages and disadvantages of its decision. **(4 Marks)**

QUESTION FOUR.

Three companies namely: Rugarama Brewery Ltd, bravo beverages Ltd and Carmelite drinks Ltd have been operating in the beverage industry for the last 4 years. These companies have been eying to finance their investments from the stock markets and have now decided to list their shares on the Rwanda Stock exchange (RSE). As part of the disclosure requirements they have released their financial performance for the past of which one analyst on the RSE summarized as follows:

2017	**Rugarama**	**Bravo**	**Carmelite**
Net profit (Rwf)	150 million	100 million	80 million
Dividend per share (Rwf)	300	200	180
Share capital (Rwf 1,000 per share)	300 million	250 million	400 million
Capital expenditure (Rwf)	-	50 million	-
2018			
Net profit (Rwf)	25 million	120 million	105 million
Dividend per share (Rwf)	500	160	-
Share capital (Rwf 1,000 per share)	300 million	250 million	400 million
Capital expenditure (Rwf)	-	80 million	-
2019			
Net profit (Rwf)	600 million	120 million	140 million
Dividend per share (Rwf)	900	320	150
Share capital (Rwf 1,000 per share)	400 million	250 million	350 million
Capital expenditure (Rwf)	-	40 million	-

Bravo beverages Ltd would like to finance the level of 2020 capital expenditure by additional borrowings. It is assumed that the capital expenditure requirement will be 65% more of the level of 2019. Bravo has already received the approval for its listing on RSE and analysts have estimated that its shares will be floating at Rwf 1,138.32 per share. Currently Bravo Beverages has issued a corporate bond of Rwf 120 million.

The bond is currently trading at Rwf 922.25 per each Rwf 1,000 bond note.

Because of its constant net profit coupled with expected listing on stock exchange, Bravo Beverages Ltd is considering issuing an additional corporate bond to finance 2020 capital expenditure and it is expected that the bond price will remain constant. The industry gearing level is 40% debt and has been judged to be an optimum capital structure.

REQUIRED:

a) Explain the dividend policy each company has been adopting in the last 3 years.

(15 Marks)

b) Assuming the market is efficient, with no taxes on dividends and insignificant transaction costs, explain the relevancy of any dividend policy adopted by a company. How would your answer change if the assumptions above were relaxed?

(5 Marks)

c) Compute the current capital structure of Bravo Beverages Ltd and advise Bravo beverage Ltd whether the level of proposed debt through additional bond issue will take it to the industry's gearing level. What else can Bravo Beverages Ltd do to attain the industry's optimum gearing level **(5 Marks)**